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International Economic Situation;
Welcome to Hard Times

We face tough, interrelated and long-term problems in the international economy--sluggish growth, stubborn inflation, and excessive dependence on imported oil. These are little changed, except for worsening, since their appearance in the early 1970's. Solutions to these problems will be more effective if they are the product of a continuing process of consultation and coordination among the major actors in the international economy. These fundamental problems have spawned a set of related problems, which also plague the world economy.

Specifically, this paper address the need to:

-- ensure the effective recycling of OPEC surpluses to LDCs with balance of payments deficits and the adoption by LDCs of proper policies to meet the new international environment; the problem will be to find the proper mix between short-term financing of deficits and the necessary adjustment, in the long-term, of such deficits without reducing growth rates to the point at which political and social instability results;

-- to monitor and perhaps find ways to assist extra-ordinary balance of payments problems in important LDCs;

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-- resist powerful tendencies toward protectionism, which many of the other problems exacerbate;

-- improve the coordination of national economic policies, thus reducing the tendency toward exchange rate instability, and interest rate wars.

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Recycling of OPEC Oil Revenues

This is widely perceived as the single major problem now facing the international economy. However, its dimensions and timing are unclear at present.

The problem is basically simple. With the price of oil doubled in the past year, some OPEC producers will again run gigantic surpluses. [redacted] oil-importing countries will run a corresponding deficit which must be financed if they are to avoid abrupt and drastic retrenchment of their economies. The industrial countries and the high income LDCs will be able to get financing from private banks. The low-income LDCs do not have such access and are heavily dependent on concessional flows. The bulk of the aggregate LDC deficit is in the high income LDCs.

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The IMF role is extremely important. The Fund is the centerpiece of our strategy for getting through this period. Its business is adjustment, providing financing to cushion the transitional adjustment problems of a country, allowing the country room and time to adjust more gradually and with less disruption. Adjustment cannot be avoided, though many countries try, but it can be eased. New structural adjustment programs in the World Bank (IBRD) can supplement the Fund's operations.

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The Fund will need sufficient financial resources to induce and foster prompt, gradual, but adequate adjustment. The request for a 50 percent quota increase now before Congress is crucial. The IMF now has authority to try to borrow from surplus countries (i.e. OPEC). The Fund will also need to be more flexible in terms of the length of the adjustment period and amount of financing it provides. Discussions about how to provide such flexibility are now underway in the Fund.

Basket-Case Countries

Some countries already have chronic payments problems. Most failed to adjust adequately to the 1973-74 oil price increases. Many show a pattern of overspending and rapid monetary growth, designed to spur development or provide extensive social benefits. Most have borrowed externally to supplement low domestic savings rates. The result has generally been virulent inflation and eventual real declines in economic performance. For most, the fiscal and monetary policy errors were compounded by structural weaknesses which impede both development and adjustment.

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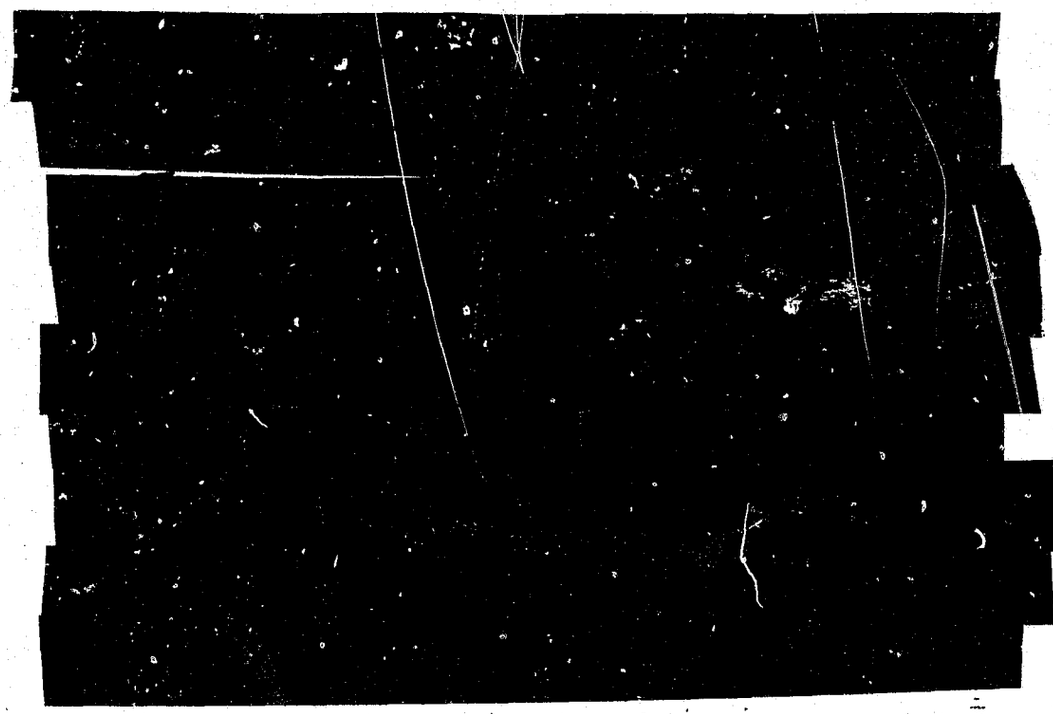

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Monetary Problems

The transition of the international monetary system from the fixed-rate Bretton Woods framework of the period 1947-71 is underway, but neither the timetable nor the new structure is yet perceived. The system is now drifting from a primary reliance on the dollar to reliance on a set of key currencies, including the dollar. An unregulated multicurrency reserve system is regarded as inherently unstable by most observers. Yet there is no agreement on how to control the evolution of the system, or what its ultimate form should be.

The Substitution Account, proposed by the U.S. as a small step toward the goal of making Special Drawing Rights (SDRs) the primary reserve asset of the system, remains unagreed. This limited proposal would have allowed official dollar holders to exchange "excess" dollars for claims denominated in SDRs and permitted countries to diversify out of dollars outside the exchange markets. In the final analysis, the Substitution Account would have provided only marginal benefits as it did

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not address the major problem in dollar diversification: the private holders.

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It should be recognized that exchange rate instability is a symptom of a more fundamental problem: divergent national economies and national economic policies. Exchange rates are bound to fluctuate if economies have divergent inflation and growth rates. The problem is that exchange rate changes make economic management more difficult.

Trade

The Tokyo Round of the Multilateral Trade Negotiations (MTN) completed in 1979 was a major success in reducing both tariff and non-tariff barriers. In most cases, tariffs are no longer a major barrier to trade among industrialized countries. Average tariff rates in these countries will be cut, in eight annual installments (which begin January 1, 1980), to about 4%. Some sensitive sectors, such as textiles, chemicals, and footwear, continue to be protected by high tariffs.

The most significant achievements of the Tokyo Round, however, were the agreements on the codes to restrict non-tariff barriers (NTBs). As tariff rates have declined, countries have increasingly used NTBs to keep out imports. Agreement was reached on codes for Subsidies and Countervailing Duties, Antidumping, Customs Valuation, Licensing, Technical Barriers to Trade (Standards), Trade in Civil Aircraft, Government Procurement, Diary and Beef. Negotiations continue on codes for Safeguards and Commercial Counterfeiting These codes should increase discipline and transparency in the international trading system. Potentially divisive disputes can now be settled more easily under the auspices of the codes and the GATT. Implementation of the agreements will be equally important.

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The conclusion of the MTN, on the other hand, has removed a major force for trade liberalization. Coupled with a worldwide slowdown in growth, this has resulted in a marked rise in protectionist pressures. In the U.S. there are serious efforts underway to secure increased protection in the automobile, textile, steel, and footwear sectors. In Europe pressures are currently concentrated in agriculture and synthetic fibers. Unless the pressures are contained, they could lead to competitive rounds of retaliation, that would be costly to our economies and put heavy strains on our relations with other Western countries. It is therefore essential that we and our trading partners resolve trading problems before they become unmanageable. This will be especially difficult for the U.S. in an election year.

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"Falling as yellow or red or white rain, it causes convulsions, nausea . . . and death."

MEDICINE FROM THE SKY

JIM LEACH

Laotian tribespeople call it "medicine from the sky." Falling as yellow or red or white rain, it causes convulsions, nausea, bleeding from the nose and mouth, and death.

Lethal chemical agents sprayed from planes and helicopters or delivered in rockets which explode above ground releasing clouds of deadly gas or dust, have been used since 1975 by Vietnamese forces against dissident groups in Laos and Kampuchea.

Evidence is mounting that similar deadly chemical weapons have been employed in recent months by the Soviets against Afghan resistance forces and by the Ethiopians against Eritrean rebels. Uncorroborated reports also exist that the Vietnamese may have "warned" the Chinese of their capacities by controlled usage of chemical weapons during Chinese brief border incursion in [illegible] 1979.

The effects [illegible] have been described by those who have witnessed them and paradoxically, to be ignored by civilized people who have difficulty facing up to uncivilized behavior. But it is clear that there is an ominous trend toward legitimization as well as proliferation of chemical weapons usage. Reports, in fact, are beginning to surface of chemical weapons preparation being made by both sides in the Iranian-Iraqi conflict and of recent purchases of chemical weapons by countries as disparate as Syria, Libya and India. And of direct strategic importance to the United States, the Soviet Union and its Warsaw Pact allies have substantial stockpiles, as do North Korea and to a lesser extent Cuba.

The perversion of science involved in the exploitation of chemical weapons represents one of the tragedies of the 20th century. First utilized by the Germans at Ypres, Belgium, in 1914, poison gas resulted in casualties estimated as high as 1,300,000 during World War I. In response to the atrocities inflicted during the war, the Geneva Protocol was negotiated in 1925 prohibiting gas and bacteriological methods of warfare. More recently, few instances of the employment in combat of lethal chemical agents have been documented. Chemical weapons were employed sporadically by Mussolini's troops against Ethiopia in 1935, by the Japanese in China and Taiwan in the late 1930s, and by the Egyptians in Yemen during the mid-1960s.

The renewed use of these reprehensible weapons underlines the possibility that, without new international sanctions an enormously expensive and dangerous arms race in chemical weapons may be in the making.

The Soviet Union possesses the world's largest stockpile of chemical weapons and Russian military doctrine emphasizes chemical warfare as part of a triad of weapons of mass destruction. However, unlike the other two arms of the triad—biological and nuclear—chemical weapons are considered "conventional" in the sense that their usage implies a lower threshold strategic option. In fact, Indochina, Afghanistan and perhaps now East Africa have provided the Soviet Union with remote Third World battlefields where sophisticated chemical weapons have been tested both for effectiveness and acceptability.

The results are apparent. Whereas in the first part of this century chemical weapons were applied with terrifying consequences to trench warfare, in the past few years they have been employed with equally profound effect in guerrilla insurgency settings.

In utilizing chemical weapons in Afghanistan and encouraging its surrogates to wield them elsewhere in Asia and Africa, the Soviet Union may have misjudged the consequences of its actions. In the face of superior Soviet chemical warfare training and testing, the US Congress this past September overrode administration opposition and committed our government to the construction of a nerve gas production facility in Pine Bluff, Arkansas, and to substantial downstream funding for a new generation of chemical weapons. The British, too, are devoting more resources to chemical weapons research, particularly related to defensive equipment, but the strategic